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## Starting a New Business: Choosing the Right Entity for Your Business

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As a startup founder, you cannot wait to change the world, but one of the most important issues you will need to address is choosing the type of entity to form to conduct your business. Angel investors and VCs usually like to fund founders who know what they are doing and forming a company can send them this signal.

In general, a new business owner may choose to conduct business through one of the following means:

- as a sole proprietorship;
- through a corporation;
- through a limited liability company; or
- if there are multiple business owners, through a general partnership or a limited partnership.

This article discusses the three most common ways new business owners conduct business as a start-up: (i) sole proprietorships; (ii) corporations, which are often further specified as C corporations or S corporations; and (iii) limited liability companies. While this article will briefly discuss sole proprietorships, most new businesses or start-ups are conducted through a separate legal entity, such as a corporation or a limited liability company.

### Sole Proprietorships

A business owner may choose to conduct his or her business as a sole proprietorship. A sole proprietorship is a business owned and operated by one person. A sole proprietorship is not a separate legal entity. While a sole proprietorship may have some advantages (such as ease of conducting business and essentially zero organizational expenses (other than possibly obtaining and maintaining a fictitious business name or DBA)), it is significantly outweighed by a huge disadvantage – the sole owner has personal liability. In other words, the business owner is personally liable for all of the debts and liabilities of the business – meaning the business owner’s personal assets are at risk and subject to the debts, liabilities and claims arising from the business. For this reason, most new business owners choose to form a separate legal entity to conduct business.

### Corporations

A corporation is formed in California by the filing of articles of incorporation with the California Secretary of State’s Office and in Delaware by filing of certificate of incorporation with the

Delaware Secretary of State’s Office. The corporation is owned by its shareholders who purchase or acquire stock of the corporation. Shareholders may also elect to enter into a shareholders agreement to set forth their rights and responsibilities.

A corporation is a legal entity that is separate and distinct from its owners or shareholders. As such, a corporation’s debts and liabilities are also treated as separate and distinct from the debts and liabilities of its shareholders. In other words, unlike a sole proprietorship, the shareholders of a corporation are generally not personally liable for the debts or liabilities of the corporation – a corporation provides a shield or protection against personal liability of its shareholders.

Corporations must follow corporate formalities and requirements required by its articles of incorporation, bylaws and/or under applicable state laws. These formalities include having adequate capitalization, having a board of directors, having certain executive officers, having not less than annual meetings of its shareholders and directors, and maintaining separate books, records and bank accounts. The failure to follow corporate formalities may make the corporation more susceptible to claims of alter ego liability or piercing the corporate veil in which the corporation’s shareholders can be held personally liable for the corporation’s debts and liabilities.

There are two types of corporations – C corporations and S corporations. Both C and S corporations share the above characteristics of a corporation, but each have differing characteristics, advantages and disadvantages.

### C Corporations

A C corporation is a more common type of corporation than an S corporation. One of the primary advantages of a C corporation is that a C corporation allows new business owners more flexibility in structuring the corporation’s capital structure. Unlike an S corporation, a C corporation may have different classes of stock, with differing rights, preferences and privileges, and are not limited by the number or type of shareholders. Further, if you are planning on raising money with VCs and PE firms, those investors are generally most comfortable investing and dealing with a C corporation incorporated in Delaware.



A significant disadvantage of a C corporation is that it is subject to double taxation (whereas an S corporation is not subject to double taxation). Double taxation means that the corporation is taxed on its profits and when distributions are made to the corporation's shareholders, the shareholders are also taxed on such distributions.

### **S Corporations**

An S corporation is formed in the same manner as forming a C corporation, but an S election must also be filed with the Internal Revenue Service in a timely manner. The primary advantage of an S corporation is that it is treated, for tax purposes, as a "pass-through" entity – i.e., the profits and losses of an S corporation are passed through to the shareholders and the S corporation is not subject to double taxation.

A significant disadvantage of an S corporation is that an S corporation is somewhat inflexible in terms of permissible capital structure. An S corporation may have only one class of stock. For example, an S corporation may not have both common stock and preferred stock. Further, the number of shareholders currently cannot exceed 100 shareholders and only certain types of shareholders may be shareholders in an S corporation. For example, another corporation cannot be a shareholder of an S corporation.

### **Limited Liability Companies**

A limited liability company (or LLC) is formed in California by the filing of articles of organization with the California Secretary of State's Office and in Delaware by the filing of certificate of formation with the Delaware Secretary of State's Office. The LLC is owned by its members who purchase or acquire membership interests in the LLC. The rights and responsibilities of the members are governed by an operating agreement entered into by the members. The LLC may be managed by the members or, if so designated, may be managed by one or more managers.

Like a corporation, an LLC is a legal entity that is separate and distinct from its owners or members. Like a corporation, an LLC's debts and liabilities are also treated as separate and distinct from the debts and liabilities of its members; i.e. the members of an LLC are generally not personally liable for the debts or liabilities of the LLC.

Like an S corporation, an LLC is treated, for tax purposes, as a "pass-through" entity – i.e., the profits and losses of an LLC are passed through to the members and the LLC is not subject to double taxation.

Unlike an S corporation, the members of an LLC have significant flexibility in structuring the LLC. For example, an LLC may have multiple classes of membership interests, each with differing rights and obligations; there is no limitation on the number of members; and there is no limitation on the type of members. Further, members have flexibility in determining distributions and allocations of profits and losses.

One of the disadvantages of an LLC (and also an S corporation) is that institutional investors, such as private equity or venture capital firms, in general do not like to invest in pass-through entities such as LLCs.

Which type of entity is the right one for your start-up?

The answer to this question is – it depends on a number of factors, including:

- the nature of your business
- whether there will be one or more than one owner
- whether pass-through tax treatment is of significant importance
- the nature of the proposed owners or investors
- whether there will be institutional investors

Choosing the right entity is an important step in starting your business. You should consult with your legal and tax advisors from the outset to avoid mistakes that could be costly to you and your start-up down the road.



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